



1947

Monthly Letter on Economic Conditions Government Finance

New York, March, 1947

General Business Conditions

THE resumption of the rise in commodity prices is the feature of the business news during the past month. The spectacular advances have been in farm products, with hogs up to an all-time record top of \$30 and wheat around \$2.50 in Chicago, highest since World War I. But in other basic commodities also, both domestic and imported, advances have been numerous. Prices of manufactured goods, with few exceptions, are strong.

In each of the markets affected special reasons for the rise are cited. However, in a movement so widespread the cause to some extent must be general. The inflationary forces represented by the swollen money supply, swollen money incomes and export demands have continued to outweigh other influences, and inflationary and speculative psychology evidently is still easily aroused in some quarters, despite the caution with which most business men are conducting their affairs.

Many people came to believe last Fall, after the drop in the stock market and the rapid rise in living costs, that signs of recession in business would show by the end of the first quarter. This opinion was strengthened by breaks in prices of cotton, furs and many foods and the reappearance of markdowns in retail stores. However, the quarter is two-thirds gone, and business indicators still point upward. Cotton and food prices have rallied, the price indexes are all at new highs, trade is active and demands on the industries show no slackening except in limited and special cases. Predictions of a decline in textiles this Spring were frequently offered, but mills are still sold some months ahead at high prices; in some goods allotments are the rule and nearby deliveries can be had only from second-hands at premiums. Even in the fur markets, where markdowns of garments at retail have been heavy, raw furs have recovered part of their price drop.

Trade and Production High

General retail trade has shown a smaller margin of gain over last year than was the case last Fall, but the comparisons have been with a better than seasonal showing a year ago, and department store sales on a seasonally adjusted basis have been on about the same level as at Christmas time. Merchants have had the problem of moving goods for which, by reason of price or quality, customers are no longer eager. However, markdowns and clearance sales were always expected to be heavy as peacetime qualities returned to the markets, and fears that such adjustments might be the forerunner of a general slump so far have not been substantiated.

Production has moved into new high ground. The steel industry, under the drive of insistent demand from consumers who are short of steel, has lifted its output above 94 per cent of capacity, although this involves operation of some

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high cost units and is possible only because mills are scouring the country and paying uneconomically high prices for scrap metal. Automobile production has increased slowly in the face of shortages of parts and materials; most companies say unfilled orders are gaining although the Spring selling season is still a few weeks off and despite fears in some quarters that cars are being priced too high for buyers' pocketbooks. Textile output is still rising.

The Federal Reserve Board's index of aggregate industrial production declined in December, due to the coal strike, but the recovery in January was sharp. The index for the month stood at 188 (1935-39 = 100), a new postwar high. Probably February will show another advance.

Effects of the Price Rise

Current reports therefore are of a nature to give a high degree of satisfaction, for the time being at least, to farmers, to manufacturers in most lines, and in the main to merchants and distributors also. Whether the economic situation actually has been strengthened or weakened by the month's developments is another question. Most fears as to the outlook for 1947 have been based on belief that the rapid rise of prices and living costs last Fall would price goods out of the market, that the effects would show as the most pressing demands were satisfied, and that speculation and inventory accumulation would be followed by a reaction. Many qualified observers have pointed out these dangers and advocated restraint in buying, reduction of prices, hard work and saving to keep the situation in order. Improvement in sentiment during the Winter was based largely on the evidence of caution and of readiness by retailers particularly to make adjustments, and also on the declines in food prices toward the end of the year and the prospect that the cost of living might soon turn downward.

If these views were warranted, the resumption of commodity price advances is to be deplored rather than welcomed. It defers hope of a downturn in the cost of living. Thereby it raises the danger that wage demands will be larger and more insistent, possibly leading to a fresh round of strikes or to another turn of the wage-price spiral. It augments the danger that excessive commitments may be made at inflated prices. To the extent that higher food prices take more out of consumers' pocketbooks, factory workers and city people will have less to spend on other goods. Where the rise forces advances in merchandise prices, distributors will have to cover requirements at the risk that their customers

may not buy when the goods reach the counters sometime hence.

It is true that higher farm prices will produce a higher income for farmers and increase their buying power for the products of factory workers. However, prosperity depends not upon what any population group can get for its product, but upon equitable relations between prices of all kinds of goods and services and the incomes of all groups. In previous issues of this Letter, as well as in analyses of the situation in many other quarters, the view has been presented that price and income relationships would be in better balance, and better calculated to prolong a high level of production and trade, if food prices would come down. The rise in prices of the farm products included in the Bureau of Labor Statistics wholesale price index, from 1939 to the present, has been 160 per cent, while all other prices have risen 60 per cent. This is not a precise measure of imbalance, for agricultural prices were too low in 1939. But farmers have no complaint on that score now, and it is the purchasing power of other groups of the population which causes concern.

The Outlook

Whether depressing consequences actually flow from this resumption of the price rise will depend first upon the further course of the markets, and second upon the policies of business men and union leaders. Some of the influences raising farm prices have been quite temporary in character, such as interference of winter weather with transportation and marketing, the seasonal decline in hog slaughter, and possibly also the psychological factors. Moreover, the rise does not alter the opinion of authorities on the agricultural outlook that in the long run, and probably not later than the latter part of this year, farm prices will have to recede. Prices are now supported by an enlarged export program, but a substantial part of these exports is being donated by this country to avert starvation abroad and another part is being financed by U. S. Treasury credits. The American people will want to continue these exports as long as they are required. It is plain that they will be greater in 1947, and that their effects will be felt longer, than had been expected. But our farmers will not continuously enjoy these markets, and when they shrink, prices must be expected to shrink with them.

Meanwhile the situation holds various dangers, some of which have been alluded to. One is the danger that an unwarranted confidence in the price level, and in the continuation of

inflationary advances, will spread. Inflationary psychology induces speculation, and the rise increases inventory hazards. Even people who realize the dangers may be forced to buy to stay in business. Another is the danger of further increases in farm land prices, despite fears that present advanced prices in many cases cannot be supported by the value of production from the land in the years to come. In both cases the need is for restraint, and a cautious view.

The paramount danger, however, is that the price rise will cause the labor unions to press their wage demands harder and further than has recently seemed probable. The argument that wages should be raised to compensate for higher food prices overlooks many other factors. Mainly it overlooks the fact that costs and prices of other goods would be raised, and that everyone who did not get the wage increases would be penalized not only in the cost of food, but in the cost of all the products of organized labor. In the longer view, it overlooks the graver imbalance that might exist a few months from now if factory wages, costs and prices were raised, only to have farm prices fall. Wage rates, once lifted, become relatively fixed and inflexible. Farm prices, on the other hand, at all levels above government support prices, are set in free markets and must equate supply and demand.

The main interest of the farmer, of labor, of business men and of every group of the population should be in balanced prices and economic stability. The remedy for price increases that threaten stability is to buy less, not to do things that will push them up further. What is now needed to strengthen the situation is precisely what was needed last Fall, namely, industrial peace, large and efficient factory and farm production, lower costs and prices, wage stability, and finally the kind of caution and restraint that will keep inventories and commitments in order and avoid pyramiding the demands on the markets.

The Budget and Tax Relief

On February 14 a legislative budget for the Federal Government's 1948 fiscal year was presented to Congress by the Ways and Means and Appropriations Committees of the House of Representatives and the corresponding committees of the Senate. This action was taken under provisions of the Legislative Reorganization Act of 1946, designed to place appropriations under better control and to put a check rein on the public debt. The Legislative Reorganization Act, approved by the President last August, requires the four concerned committees:

to meet jointly at the beginning of each regular session of Congress and after study and consultation, giving due consideration to the budget recommendations of the President, report to their respective Houses a legislative budget for the ensuing fiscal year, including the estimated over-all Federal receipts and expenditures for such year. Such report shall contain a recommendation for the maximum amount to be appropriated for expenditure in such year which shall include such an amount to be reserved for deficiencies as may be deemed necessary by such committees. If the estimated receipts exceed the estimated expenditures, such report shall contain a recommendation for a reduction in the public debt. Such report shall be made by February 15.

The report shall be accompanied by a concurrent resolution adopting such budget and fixing the maximum amount to be appropriated for expenditure in such year. If the estimated expenditures exceed the estimated receipts, the concurrent resolution shall include a section substantially as follows: "That it is the sense of the Congress that the public debt shall be increased in an amount equal to the amount by which the estimated expenditures for the ensuing fiscal year exceed the estimated receipts, such amount being \$. . ."

The concurrent resolution referred to in the last paragraph is now under discussion in Congress. As this Letter goes to press no decision has been made as to whether the committee recommendation of a \$6 billion cut in expenditures, or a somewhat smaller one, will be approved. The House has accepted the \$6 billion cut, the Senate one of \$4½ billion and no agreement between them has yet been reached.

The legislative budget approved by the Committee estimated revenues \$1.4 billion higher than did the President in the executive budget presented in January and proposed to limit expenditures to \$31.5 billion:

(In Billions of Dollars)		
	Executive budget	Legislative budget
Net receipts	37.7	39.1
Expenditures	37.5	31.5
Surplus	0.2	7.6

The rise in estimated revenues primarily reflects the acceptance by Congress of the President's recommendation to keep the excise taxes at their wartime rates after June 30 of this year. The reduction in expenditures reflects a widespread determination to bring down the scale of government spending. Even at the proposed level of \$31.5 billion, expenditures would run \$900 for every American family. This compares with \$290 in 1939 and \$112 twenty years ago.

There is agreement on all sides that the debt must be cut down and many feel that some tax reduction is also essential. Debt retirement will make a start at relieving the upward pressure on prices coming from the swollen supply of money purchasing power and from vast foreign demands for our products, and also make a dent in the \$5 billion annual interest charges on the debt.

On the other hand, if too little is done to relieve tax discouragements to work, enterprise and risk-taking, we take the chance of not being able to maintain the production and employment levels we want after the abnormal demand arising from war shortages has been satisfied. Considerations on both sides are so strong that many people have been led to support about an even division of the prospective surplus between debt retirement and tax reduction. Others have laid the emphasis on one or the other as alternatives.

In considering a desirable rate for paying off debt, and contracting bank holdings of government securities and of deposits, one thing to remember is that social security taxes are not counted in the regular government revenue but become available in large part for paying off obligations held by the banks and by the public generally. Federal trust fund accumulations may add \$3 billion a year or more to the retirement of publicly held debt which is made possible by a budget surplus.

The pressing, immediate problem is to make real the paper reduction in expenditures that will be called for in the concurrent resolution.

Proposals for Tax Reductions

Various proposals have been offered with respect to a tax cut, but there seems to be a nearly unanimous feeling that the tax on individual incomes is the sorest point in the whole system. Corporations last year were relieved of the excess profits tax. The decision has already been made to carry on with the present excise taxes. The excises have a practical merit of being relatively easy and convenient to collect and they provide a needed element of stability to the government revenue. Not least of all they provide a means of collecting some taxes from those who for one reason or another do not pay the income tax.

On the question of how to reduce personal income taxes a number of differences in point of view have become apparent. Congressman Knutson of Minnesota has introduced a bill (H.R.1) which proposes to give every taxpayer a 20 per cent reduction in his tax, except that taxes levied on incomes above \$302,000, relatively few in number, would be cut 10½ per cent instead of 20 per cent. The opposite proposal is that income taxes be reduced by raising the present personal exemptions of \$500 for the taxpayer, his wife (if without income), and each dependent, and thus relieving several million persons from the obligation to pay any income taxes at all.

As to long run tax adjustment, Treasury officials are reported as of the view that such adjustment might give the taxpayer in non-community property States the same treatment the taxpayer gets who resides in a State where the income of the husband and wife can be split evenly for income tax purposes. Others have recommended that, to strengthen incentives given to corporation management through stock option arrangements, profits from such stock should be taxable under lower rates as capital gains rather than as salary income. Still others have presented recommendations for relieving present double taxation of dividend income, which discriminates against the investment of equity capital in corporations.

The need for a painstaking review and adjustment of our present tax system is great, but there is a strong argument right now for doing something simple. Detailed changes take a long time to work out, and the burden is too great to delay action. It is important to provide relief at the point where it will do the most good in stimulating work and enterprise so that we can keep going ahead when deferred demands and accumulated buying power have run their course.

Fate of the Big Income

Relatively few people, apparently, have any real idea of what big slices the income tax takes out of larger incomes under the present law. This is confirmed in a poll conducted by George Gallup of the American Institute of Public Opinion in January. The question was asked:

About how much do you think a married man with two children who earns \$50,000 a year now pays in federal income taxes?

The typical answer was \$9,000. Actually, Mr. Gallup points out, the tax on a net income of this size is about \$24,000.

Considerable attention has been given in the public discussions to the individual with a net income of \$300,000 or \$1,000,000. It would have been interesting to know how steeply the public thinks such incomes are taxed. Actually, a \$300,000 net income shrinks to \$66,000 after taxes; the \$1,000,000 drops to \$161,000.

In a talk at Columbia University last month Mr. R. C. Leffingwell, Undersecretary of the Treasury during the first World War, presented a reasonable prescription for individual income taxation:

In war or peace the straight personal income tax, graduated according to ability to pay, has long been thought the best tax. It is our chief reliance. It should tax small incomes, but not too severely, and tax large incomes most severely, but not to kill the goose that lays the golden eggs of enterprise and of revenue.

One very practical argument in favor of reducing the present 86½ per cent tax rate on taxable income above \$200,000 is that the experiment might *increase* rather than *reduce* the tax revenues. It may be observed from the reports of the Bureau of Internal Revenue that the principal effect of raising the top rate from 25 per cent twenty years ago to 88 per cent in 1942 was to cut down the number of persons with taxable incomes of extraordinary size. The higher rates did not produce correspondingly larger amounts of revenue despite a national income level half again as large:

	1926-28 average	1942
National income	\$77,000 million	\$122,000 million
Incomes over \$300,000 —		
Total amount	\$ 1,669 million	\$ 376 million
Taxes paid	\$ 281 million	\$ 292 million
Top tax rate applicable.....	25%	88%
Number of returns.....	2,276	654

Here is perhaps a demonstration of the principle that the power to tax is the power to destroy. It may also show the way money avoids the taxable type of employment, and taxes thus distort and slow down the economic machine.

The Tax on Initiative

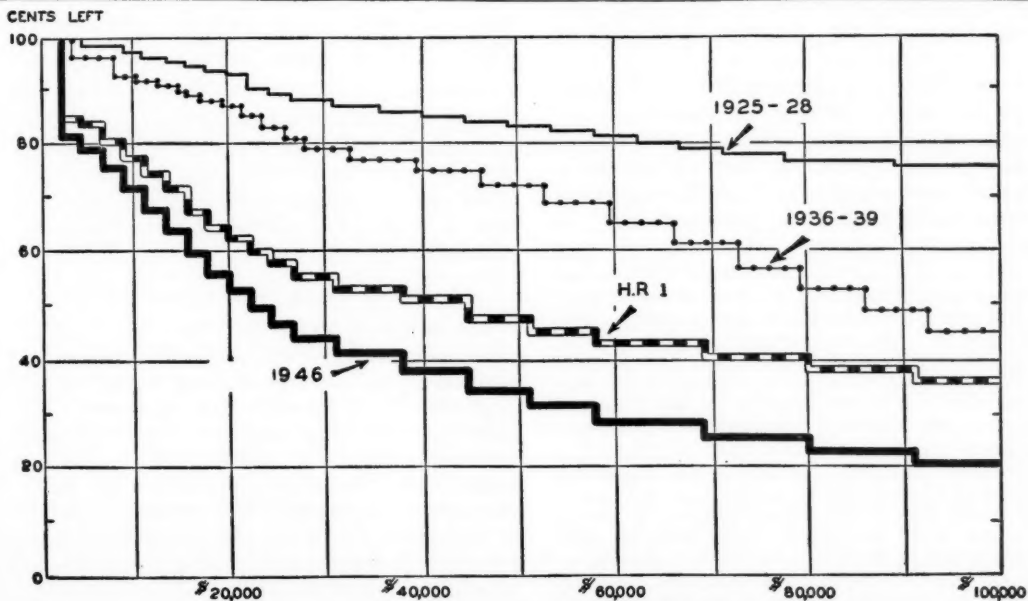
For 99.98 per cent of the taxpayers, it is the long scale of ascending tax rates up to \$100,000 that counts. Above \$100,000, taxes leave less than 20 cents out of an additional dollar's earnings for the taxpayer:

What an Extra Dollar of Earnings is Worth to the Taxpayer at Various Income Levels

If his gross income is	For a married man with two dependents the taxpayer has left from an additional dollar's earnings:		
	Under the present law	in 1936-39	Under H.R. 1
\$ 2,000	\$1.00	\$1.00	\$1.00
4,000 .....	.81	.96½	.85
8,000 .....	.75	.96½	.80
16,000 .....	.59	.89	.67
32,000 .....	.41	.79	.53
64,000 .....	.29	.65	.43
128,000 .....	.15½	.38	.32½
350,000 .....	.13½	.30	.22½

The taxpayer is assumed to be a married man with two children and 10 per cent of his gross income is allowed for legal deductions. The chart below tells the same story, for gross incomes up to \$100,000.

Besides the curve for the present law, the chart shows how much was left to the individual out of an extra dollar's earnings under the laws in effect 1936-39 and 1925-28 and also how much would be left if the "across the board" proposal embraced in H. R. 1 were to be adopted. It is worthy of note that the latter proposal is a good deal stiffer for everyone than the schedule in effect 1936-39, after radical upward revisions of surtax rates in 1932 and 1936. The restrained progressiveness of the 1925-28 schedule was notable for its productiveness of revenues from the upper income groups.



CENTS LEFT TO TAXPAYER OUT OF AN EXTRA DOLLAR'S EARNINGS

At various gross income levels up to \$100,000 under Federal income tax laws in effect in 1946 (and currently), in 1936-39, in 1925-28, and under the H. R. 1 proposal. For a married man with two dependents.

Under the present law, from \$22,000 upward the taxpayer's further advancement is of greater advantage to the Bureau of Internal Revenue than it is to himself — he can keep less than half of an extra dollar's earnings. At \$91,000 he can keep only 20 cents out of the extra dollar. At this point, incentive to make an extra dollar is close to the vanishing point.

As pointed out earlier, people generally have little conception of the extent to which success has been penalized through taxation. Nor do they have any real sympathy for such penalties. This is confirmed by answers to a second question in the poll conducted by the American Institute of Public Opinion:

About how much do you think a married man with two children who earns \$50,000 a year should pay in federal income taxes?

The median average answer was \$7,500. The tax now levied on an income of this size is about three times as much as the typical respondent thought was "right."

Shrinking Wages of Management

The springs that drive men are many and varied but, whether for good or ill, money and material welfare come high in the list. This seems to have been true in almost all times and places. All over the world we find differentials in income with more compensation going to those who work harder, risk more, and undertake bigger responsibilities. Steeply progressive income taxes neutralize the value of these differentials; as anyone goes up the ladder he finds that the differential he "enjoys" is worth more to the tax collector than it is to himself.

A timely new report of the Committee on Post War Tax Policy, "A Tax Program for a Solvent America, 1947," has the following to say in discussing this side of the problem:

It is particularly important that this (income tax) load be eased through those income levels in which are to be found the bulk of the incomes received by the managerial group. The services of this group are of peculiar importance in a free enterprise system. They involve the integration of labor and capital into an efficient working team; the planning, organizing, and directing which are so essential to effective, coordinated effort; and the energizing drive which is fundamental to economic growth . . .

Ordinarily, as one rises in the income scale, the ability to command a greater income involves more and harder work, greater responsibility, often a progressively severe strain upon health and strength. Somewhere, for each individual, there is a point beyond which the gain is no longer worth the candle. For some, this breaking point may lie beyond the half-way mark, while for others it may lie below that mark. Tax rates, however, must be of general application, and we have come to the conclusion that a combined normal and surtax scale which

rises above 50 per cent would seem to the great majority to go beyond a fair and reasonable standard.

Twenty years ago an unusually successful man earning \$100,000 a year (four exemptions and 10 per cent allowable deductions) would have had \$86,400 after taxes to reward his efforts. In 1939 he would have had \$68,700 left and in 1946 \$46,000. On top of this has come the sharp wartime increase in the cost of living. To give today's \$100,000 a year man the buying power of the \$100,000 a year man of twenty years ago, he would need "take home" pay of around \$105,000. To get this his salary would have to be \$357,000 a year of which \$252,000 would go to pay federal income taxes.

Almost needless to say, the pay for big jobs of great responsibility has shown no such increases as this. Nominally well paid business managers have been under relentless pressure to cut back their personal expenses and to give up some of the tangible fruits of their success. Meanwhile workers down the line have been enjoying sharp increases in pay after taxes, and increased buying power after allowing for prices too. Taking the average weekly earnings in manufacturing, reported by the U. S. Bureau of Labor Statistics, as the income of a typical wage earner in a family of four, we come out with the following comparison:

Year	Weekly earnings	Taxes	Earnings after taxes	Cost of living 1926=100	Earnings after taxes in 1926 dollars
1926	\$24.65	.....	\$24.65	100.0	\$24.65
1939	23.86	.....	23.86	78.6	30.36
1946*	45.74	\$0.51	45.23	120.4	37.57

*November.

This 24 per cent gain since 1939, and 52 per cent since 1926, stand in marked contrast to the sharp cuts that have taken place, since 1926 and since 1939, in the *real* wages of business executives even though they may have had large increases in salaries.

The Case for Increased Exemptions

A number of people have proposed that instead of reducing all income taxes by a flat percentage, personal exemptions should be increased from the present \$500 allowance. The CIO, in a pamphlet entitled "The Vanishing Paycheck," advocates a \$2,000 exemption for the married man and one of \$1,000 for the single person. No tax relief of this extent is feasible at the present time unless the cut in government expenditures were to go a good deal farther than is now contemplated. According to Colin Stam, Chief of Staff of the Joint Committee on Internal Revenue Taxation, a doubling of the present exemptions for single taxpayers and

heads of families — leaving dependency credits at \$500 — would remove 18 million persons from the tax rolls and cost \$5 billion.

The proper comparison with the 20 per cent "across the board" proposal would be an increase in exemptions involving the same revenue loss, or about \$3½ billion. Mr. Stam has estimated that a \$200 per person increase in the exemption limit would remove 9,900,000 taxpayers from the rolls and involve a revenue loss of \$3 billion. Based on this calculation, an increase in exemptions of \$250 per person apparently would be more or less comparable to 20 per cent "across the board" in terms of revenue loss to the Treasury.

How much dollars-and-cents advantage would there be to the individual in such an increase in exemptions instead of an "across the board" cut? The following table, presenting a few illustrative cases, is designed to bring out what income groups would stand to gain and how much:

Gross Weekly Income	Present tax per week	Tax per week if personal exemptions were raised to \$750	Tax per week under 20% cut "across the board"	Difference in favor of increase in personal exemptions
(For single man with no dependents)				
\$16.00	\$0.91	\$	\$0.73	\$0.73
25.00	2.45	1.53	1.96	0.43
37.40	4.57	3.65	3.65	no difference
(For couple with 2 children)				
42.70	....	....	....	no difference
64.10	3.65	....	2.92	2.92
100.00	10.04	6.14	8.03	1.89
166.00	23.75	19.00	19.00	no difference

The \$250 increase in exemptions has the biggest advantage over the "across the board" reduction for a single person with a gross weekly income of \$16. Such taxpayer would be better off under the increase in exemptions to the extent of 73c a week, equivalent to 4½ per cent of income. The single taxpayer making more than \$37.40 a week would be better off if the "across the board" cut were put into effect.

On the other hand, the married man with two dependent children making \$42.70 or less would have no immediate reason for favoring one plan over the other because he is not a taxpayer in any case. In this group the person with an income of \$64 a week would get the best break from an increase in exemptions. He would be \$2.92 a week better off than under the "across the board" cut. Again, this is 4½ per cent of his income. At \$100 a week, the married man with two children would be better off to the extent of \$1.89 a week or 2 per cent of his income. In comparison with the 92 per cent increase in average weekly earnings of wage earners in manufacturing from 1939 to November, 1946, a few per cent at the most to be

gained from the increase in exemptions is small indeed.

The Mass Purchasing Power Argument

Even if it were agreed that the increase in exemptions cannot make a great deal of difference to the small taxpayer — and none at all to 15,000,000 or more gainfully employed persons who now pay no tax — it might be argued that we need the mass purchasing power which would be released by giving to millions of people an extra 50 cents a week here, an extra dollar or two there. But one of the things that we learned during the thirties was that simply pumping out billions of purchasing power was not a cure-all. We also learned how steeply progressive income taxes, imposed beginning in 1932, could place a heavy drag on recovery because they lower the incentive for business enterprise.

Today we have purchasing power enough — if anything, too much, counting in the foreign demands that are pressing on our markets. We are enjoying full employment, good wages and good profits. While there are exceptions, incorporated business generally is in strong financial position, having used war profits to a large extent in repaying indebtedness and building up working capital. Credit is in abundant supply to credit-worthy borrowers. The question in tax relief is not one of making an arithmetic addition to purchasing power, but one of bolstering the incentives upon which we will have to rely to keep the ball rolling when the momentum of the war and postwar boom is lost.

Industrial Corporation Earnings

Annual reports so far published for 1946 show that American business in the aggregate had a substantially higher net income than in 1945 — although earnings before taxes were lower — and that it realized returns on sales and net worth which made 1946 one of the better years in its checkered history. There were as always exceptions to the general showing, but analysis of the reports now available from the larger manufacturing corporations shows that about three-fourths of the companies, in number, had an increase in net income over 1945. Most companies in the consumer goods industries were in this group. They had little or no reconversion problems, demand for their products was enormous, and they operated at the highest peacetime rate in their history.

About one-fourth of the manufacturing companies to report so far showed lower earnings than in 1945. These companies were chiefly the manufacturers of heavy equipment and other durable goods whose output was curtailed ser-

iously by strikes, reconversion difficulties, and shortages of materials. Even in these cases a breakdown of 1946 figures would show that, generally speaking, the losses were incurred in the first half of the year. Improvement in operating conditions and sales brought a sharp upturn in the second half, particularly in the final quarter, and in a good many cases the gains of the second half year more than offset losses of the first half.

In the aggregate, our preliminary tabulation of the reports of 840 manufacturing corporations shows combined net income after taxes of approximately \$2,049 million, compared with \$1,491 million in 1945, an increase of 37 per cent. Upon the net worth totaling \$17,251 million at the beginning of the year, the 1946 net income represented an average return of 11.9 per cent, which compares with 9.0 in 1945 and was the highest since 1941, when the rate was 12.4 per cent.

Manufacturers' sales figures show an aggregate decline of 17 per cent from 1945, due chiefly to the severe contraction in a few industries, but the number of increases and decreases was about evenly divided. For all companies reporting sales thus far, net income represented an average margin of 5.0 cents per dollar of sales, compared with 3.9 in 1945 and 6.5 in 1941.

Factors Affecting 1946 Earnings

Industrial earnings in 1946 reflected a combination of unusual and diverse factors. On the

favorable side were the high-volume operations in many lines which lowered production and overhead costs; the gradual relaxation and ultimate abandonment of price ceilings; elimination of the wartime excess profits tax, and special accounting adjustments in connection with carry-back tax credits and drawing on contingency and postwar reserves. On the negative side were the costs of reconverting plants and equipment, retraining of manpower, interruptions to production due to strikes and material shortages, and the sharp increases in wages and material costs. The varying incidence of these factors upon different companies caused extremely uneven changes in net income, as will be seen from the table; even within industry groups, the showing was by no means uniform.

Outstanding among favorable factors was the record-high volume of production and sales by large numbers of companies in such industries as food products, beverages, tobacco, textiles, rubber tires, pulp and paper, chemicals, drugs, soap, paints, petroleum refining, cement, glass and stone products. Sellers' markets prevailed as the public was eager to obtain formerly scarce goods and was interested only secondarily in the price.

Earnings were swelled also by the generally rising level of commodity prices, particularly after OPA controls were removed. During the year 1946 the BLS index of 28 basic commodities

PRELIMINARY SUMMARY OF MANUFACTURING EARNINGS IN 1945 AND 1946
Net Income is Shown as Reported—after Depreciation, Interest, Taxes, and Other Charges and Reserves, but Before Dividends. Net Worth Includes Book Value of Outstanding Preferred and Common Stock and Surplus Account at Beginning of Each Year.
(In Thousands of Dollars)

No. of Cos.	Industrial Groups	Net Income After Taxes		Per Cent Change†	Net Worth, Jan. 1		% Return	
		1945	1946		1945	1946	1945	1946
16	Baking	\$ 22,730	\$ 44,665	+98.5	\$ 226,707	\$ 224,591	10.0	19.9
15	Meat packing	34,499	67,857	+96.7	632,688	643,815	5.5	10.5
64	Other food products	82,725	142,773	+72.6	847,121	885,095	9.8	16.1
39	Beverages	74,214	154,841	+	417,917	470,016	17.8	32.9
16	Tobacco products	71,923	92,170	+28.2	763,816	821,486	9.4	11.2
36	Cotton goods	20,309	62,622	+	252,533	262,734	8.0	23.8
49	Other textile products	46,901	116,527	+	430,968	471,451	10.9	24.7
23	Leather and shoes	16,794	23,598	+40.5	223,710	224,279	7.5	10.5
17	Rubber products	61,738	123,290	+99.7	565,267	600,194	10.9	20.5
83	Pulp and paper products	38,031	89,387	+	632,611	651,831	6.0	13.7
38	Chemical products	129,404	189,099	+46.1	1,340,317	1,390,201	9.7	13.6
12	Paint and varnish	11,131	21,895	+96.7	124,171	130,917	9.0	16.7
16	Petroleum products	64,162	76,334	+19.0	746,346	781,972	8.6	9.8
34	Cement, glass, stone products	35,302	72,142	+	510,848	545,204	6.9	13.2
30	Iron and steel	160,691	236,190	+47.0	3,224,038	3,236,347	5.0	7.3
11	Agricultural implements	47,581	45,376	- 4.6	667,059	694,595	7.1	6.5
33	Building, heating, plumbing equipment....	19,426	24,003	+23.6	230,780	252,069	8.4	9.5
33	Electrical equipment and radio	69,667	41,061	-41.1	642,854	684,768	10.8	6.0
73	Machinery	33,612	38,863	+15.6	331,989	367,996	10.1	10.6
12	Office equipment	24,419	43,472	+78.0	189,680	201,923	12.9	21.5
86	Other metal products	80,742	96,511	+19.5	920,117	985,131	8.8	9.8
72	Transportation equipment	279,820	137,068	-51.0	1,917,316	2,030,413	14.6	6.8
82	Misc. manufacturing	65,652	108,862	+65.8	661,338	693,556	9.9	15.7
840	Total manufacturing	\$1,491,473	\$2,048,606	+37.4	\$16,500,191	\$17,250,584	9.0	11.9

†Increases or decreases of over 100% not computed.

(Aug. 1939 = 100) rose from 187 to 304, an increase of 63 per cent. This, however, was a source of gain that cannot be expected to recur regularly; moreover, it was partly tied up in higher-priced inventories on hand at the year-end, and is subject to being lost whenever prices turn downward.

Much of the increase in wages, as well as in material and other costs, applied only during the latter portion of the year and hence earnings did not measure fully the advance in costs. Moreover, earnings are now being subjected to increasing pressure by the passing of sellers' markets and the increase of competition.

On the other hand, in those industries that reported sharp declines in earnings or net deficits due to special circumstances during the early part of the year, the 1946 figures understate earning capacity on high volume and uninterrupted operations.

Effect of Federal Taxes

Elimination of the wartime excess profits tax of 85½ per cent (net of 10 per cent postwar refund or debt reduction credit) and lowering the corporate normal-surtax from 40 to 38 per cent (plus 2 per cent on consolidated returns), both effective in 1946, were important factors in the increase of net income after taxes. Also, severe declines in operating earnings, where they occurred, were cushioned by the use of carryback tax credits.

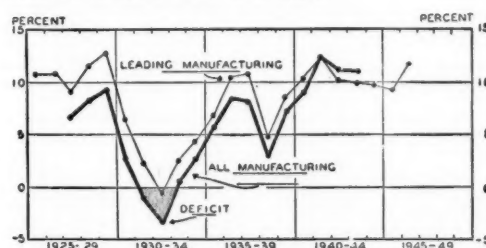
Tax reserves, where reported, absorbed about 37 per cent of the net earnings before taxes, compared with an average of 63 per cent in 1945. From this it may be estimated that operating earnings before taxes were 20 per cent lower than 1945.

Although the details as to carryback of unused excess profits tax credits in most cases were not shown separately, evidence that such credits were sizeable appeared in the reports of 98 companies which—in contrast with net tax liability in 1945 of \$207 million—in 1946 had net tax credits totaling \$138 million. Although these companies had a net operating deficit in 1946 of \$126 million, application of the tax credits, plus the use of \$6 million in general reserves, enabled them to report net income of \$18 million. Use of tax credits and reserves thus concealed in many cases the unsatisfactory level of actual operating earnings. Relief through the carryback of unused excess profits tax credits ceased to be available after December 31, 1946, although operating deficits in 1947 can still be the basis of an application for refund of income taxes paid in 1945-46.

Our final tabulation of 1946 earnings to be summarized in the April issue will include several hundred additional manufacturing reports, shown in more detailed industrial classification, as well as mining, trade, transportation, public utilities, service, and finance.

Long-Term Earnings Trend

The accompanying chart shows the annual rate of net income after taxes to net worth for all manufacturing corporations in the U. S., as tabulated by the Treasury Department from tax returns, and the rate for leading manufacturing corporations, based upon our own annual tabulations of published shareholders' reports. It will be seen from the chart that the 1946 upturn reversed a steady downtrend during the four years 1942-45, but was below the previous peaks reached in both 1941 and 1929.



Annual Rate of Return on Net Worth of All Manufacturing Corporations and Leading Manufacturing Corporations.

Average rates for leading corporations from National City Bank annual tabulations of published shareholders' reports were:

1925.....10.7	1931.....2.3	1937.....10.8	1943.....9.9
1926.....10.8	1932.....-0.5	1938.....4.8	1944.....9.8
1927.....9.0	1933.....2.5	1939.....8.5	1945.....9.1
1928.....11.6	1934.....4.3	1940.....10.3	1946 pre. 11.9
1929.....12.8	1935.....6.7	1941.....12.4	
1930.....6.4	1936.....10.4	1942.....10.1	

Balance Sheet Changes

The December 31, 1946 balance sheets of 130 manufacturing corporations having sales or total assets over \$5 million are summarized, together with comparative figures for prior years, in the composite statement on the next page.

This indicates cash drawn down slightly last year, and considerable liquidation of government security holdings, including tax notes tendered in payment of 1945 income and excess profits taxes. Inventories rose sharply, reflecting both the expanding rate of operations and higher costs for labor and materials. Although inventories at the end of 1946 were about double those of 1940, they stood at about the same relationship to dollar volume of sales, which for these companies also doubled since 1940.

Receivables increased last year, due to the expansion of trade credit on sales of civilian goods which supplemented the terminated government contracts financed in part by advance payments.

Composite Balance Sheet of 130 Manufacturing Companies with Sales or Total Assets over \$5 Million
(In Millions of Dollars)

Assets	December 31—			
	1940	1944	1945	1946
Cash	\$ 399	\$ 546	\$ 566	\$ 552
Government securities†	61	641	615	357
Receivables, net	433	801	662	771
Inventories*	1,079	1,732	1,728	2,174
Total current assets	1,972	3,720	3,571	3,854
Land, plant & equipment	2,782	2,968	3,078	3,476
Less depreciation	1,344	1,601	1,748	1,845
Net property	1,438	1,367	1,330	1,631
Other assets	358	429	345	363
Total assets	3,768	5,516	5,246	5,848
Liabilities & Capital				
Notes payable	61	195	189	241
A/c pay., accruals, etc.*	249	609	454	525
Reserve for taxes†	176	874	620	447
Total current liabilities	486	1,678	1,263	1,213
Deferred liabilities	355	378	328	593
Reserves	110	259	259	261
Capital and surplus	2,817	3,201	3,396	3,781
Total	3,768	5,516	5,246	5,848
Working capital	1,486	2,042	2,308	2,641
Current ratio	4.06	2.22	2.83	3.18

†Before deducting tax notes offset against taxes payable.

*Includes advances on government contracts.

Net property account was increased substantially by expenditures on plant modernization and expansion, as well as purchases of surplus government war plants. Because of the sharp rise in construction and equipment costs, the existing depreciation reserves in many instances will prove to be inadequate when the time comes for replacement of plant and equipment.

Increases in short-term notes and accounts payable, etc., were more than offset by the decrease in reserves for taxes. The rise in working capital reflected the building up of capital funds through retained earnings and the sale of new stock, and long-term borrowing.

This composite balance sheet of important companies illustrates industry's need for new money — which must be obtained either by borrowing or from shareholders — to be used for the modernization and expansion of facilities, for financing the current and prospective large volume of postwar production and employment, and for providing the greater number of dollars now required to handle the same physical output of goods at the higher prevailing level of wages and prices. As we look forward to the need for rebuilding and expanding to make more goods at lower costs, we should consider it fortunate that business has behind it a period of good earnings and accumulated reserves, which put it in position to go ahead on its own funds and to appeal for capital. Only by earning, saving and investing can the great needs of the world

for reconstruction, rehabilitation and the resumption of historical progress be met.

A View on World Reconstruction

Relief and aid to other countries is costing the United States Treasury over six billion dollars in the current fiscal year — as much money as was needed for all government expenditures in most prewar years. How much good this money is going to do will depend to a great extent on what each country can do to put its house in order and build a healthy basis for peace, prosperity, and trade. How a group of responsible business men from all over the world appraise the situation is set forth in resolutions on "Monetary Problems in the World of Today," adopted by the Committee on Monetary Relations of the International Chamber of Commerce meeting in Paris last December. The resolutions are based on a report prepared by Dr. Per Jacobsson, Economic Adviser of the Bank for International Settlements, and rapporteur of the Committee.

The document of the International Chamber is timely in view of publication last month of the report by the mission headed by former President Hoover on emergency relief needs in Germany. While the former was prepared earlier, and deals with broader, longer-range problems of reconstruction, its conclusions are of particular interest and importance as outlining the kind of a broad program that will be required if emergency measures are to lead to enduring recovery. The resolutions stress the need for emergency aid in many cases, and the Council of the International Chamber took cognizance of the German problem by appointing a special group "to study the economic repercussions upon the well-being of the world, and especially the countries of Europe, of the present economic state of Germany and to report to the Executive Committee at its meeting in April, 1947."

The Inflation Danger

Discussing the monetary problem, the Committee on Monetary Relations declares that "the immediate danger in most countries is now one of continued inflation. This danger must be countered." One cause of rising prices is too much money and too much government debt; another is too little production in the face of urgent needs. The report continues:

To a considerable extent, the upward tendencies of prices are due to non-monetary causes, arising mainly from destruction and disorganization brought about by the war, such as the shortage of goods, deficient production, and the rising costs largely attributable to higher wages. Among the most essential tasks are an increase in the production of power, a general recovery in effi-

ciency, and firm measures to avoid the vicious spiral of rising wages and prices. It should now be clear everywhere that until sufficient supplies become available, an attempt to improve the people's standard of living merely by raising money wages is doomed to failure, for it will simply lead to a rise in prices which will tend to imperil the integrity of national currencies.

But in many countries inflationary pressure is still largely the result of monetary causes in the form of large accumulations of purchasing power continually increased by deficit financing and a policy of excessively cheap money, which involves the monetization of debts and artificially increases the money valuation of capital assets.

Therefore, the first task is to arrest the increase in buying power by bringing budgets under control, so that no new notes need to be printed to fill the gap between expenditure and revenue. Government expenditure must be subject to a thorough overhauling so as to eliminate superfluities and prevent too large an administrative establishment from reacting unfavorably on the budget position and on the standard of living.

Stable Governments Needed

The first requisites are "a resolute government assured of adequate stability and continuity" and, when the deterioration in the position of any country or area has gone so far that serious inflation threatens, a comprehensive plan of financial reform.

Palliative measures of relief will usually be essential while efforts are being made to arrive at a permanent policy, the report points out, but stress is laid on fitting relief at the earliest possible moment into a more substantial scheme. Foreign financial aid, urgently needed by certain countries, should be used to rebuild what the war has destroyed and for other constructive developments. "If it were used to evade the task of adjustment, it might easily become a downright misfortune."

No Deep Depression in Sight

The present boom, the report reminds us, is virtually worldwide.

According to the widely accepted principles of modern business cycle policy, the task of the government is to moderate such a boom by achieving a real budget surplus, which means, among other things, the limitation of expenditure including the postponement of new public works in every practicable way. But other measures must be added, including means to guard against unduly easy conditions on the money and capital markets, and great caution in making price and wage increases and in regard to industrial expansion.

There seems to be little likelihood that the next downward turn of the business cycle will resemble the great depression of 1930-33. If a comparison is to be made, it might be better to make it with the brief recession of 1920-21. The Chamber wishes to point out how dangerous it is for wide circles to think too much in terms of past experience at a time when the fundamental conditions obtaining are in many respects totally different.

The report goes on to point out one of the troubles with fixing interest rates on government borrowings at low levels:

During the war, treasuries have had (and in some cases still have) a monopoly position on the money and capital markets and have, as monopolists, been able to fix lower rates of interest in spite of all their borrowing. But very low interest rates are not necessarily innocuous. The perpetuation of such rates would make monetary management more difficult, since one of the instruments would be lost which proved useful in the past for influencing economic developments. Treasuries and other monetary authorities should begin to think in flexible and not in rigid terms.

To restore a smoothly working international monetary system, it will be necessary to arrive at economically tenable rates of exchange to be kept stable within a system of free exchange markets for all current payments and for normal transfers on capital account. There can be little hope of establishing such a system without vigorously furthering a free exchange of goods and services.

World Fund and Bank Endorsed

The Chamber recommends that all countries should adhere as soon as possible to the Bretton Woods institutions, which, "although not perfect", offer a real chance of international monetary collaboration.

Perhaps the most urgent problem to which the Bretton Woods Bank should give its attention is the economic and financial recovery of countries that have particularly suffered from the war. In line with the principles set out above, the Chamber recommends that, however urgent the need, the lending should be done as part of a constructive scheme holding out the hope of real economic recovery on the basis of a financial stabilization.

In connection with monetary reconstruction under the aegis of the Bretton Woods organizations, the Chamber hopes for a general willingness of countries to accept "outside expert aid" without fear that doing so will be regarded as a sign of inferiority.

The U. S. as an Anchor of Stability

"A special importance," the report goes on to say, "attaches to the realization in the United States of a level of economic activity steady enough to serve generally as a basis of adjustment of prices and exchanges. The Chamber further hopes that the United States will continue to take a lead in the movement for freer trade, which is so important also from a monetary point of view."

In closing, the Chamber emphasizes a point which "is so obvious but still so important":

namely that without expansion in the output of goods and services, there can be no steady increase in the standard of living and no true basis found for a solution of the monetary problems. In fact, monetary and economic policy must be so framed as to stimulate the development of available resources and the working out of new ideas with sufficient scope given to enterprise and initiative for men to assume the risks involved in all economic progress.



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